Demand – the new direction for profit

The industry can no longer rely on the "build it and they will come" supply-driven business model that has proved so profitable until recently, notes Paul Hodges.

The World Bank had recently downgraded its 2016 global growth forecast, whilst May's US jobs report showed the lowest hiring level since 2010. These disappointments follow April's IMF report that global GDP declined last year by more than in 2009 (from USD77.8 billion in 2014 to USD73.2 billion), when measured in current USD. Our view is that they are due to the world having going through a paradigm shift in demand patterns, caused by demographic change.

The central banks may still claim that their policies are "just about" to return the global economy to long-term growth. But for those who believe demand is created by people, rather than by economic models, it is clear that a paradigm shift is underway in terms of demand patterns. The critical issue is that for the first time in history, domestic demand growth in most countries is being driven by the needs of the lower-earning, lower-spending New Old 55+ generation.

Across the world, 1 billion people are now moving into the New Old 55+ age group, where spending and incomes start to decline quite sharply. And unlike in the past, when they could be expected to die soon after retirement, the average 65-year old now has another 20 years of life expectancy ahead of them. These 'New Olders' already own most of what they need, and their incomes decline as they move into retirement. By 2030, they will be more than one in five of the global population, nearly twice the ratio seen during the SuperCycle itself.

Consensus wisdom has thus failed us, yet again. The next few years are, therefore, likely to prove very uncomfortable for many companies:

- Boards who have sanctioned major expansion projects are going to have to consider whether to proceed, or cut their losses. They face binary decisions, with no middle ground.
- Are they really clear about the potential drivers for this demand in the future? As the *Financial Times* summarised new US research from the Pew Foundation: "Companies struggle to adapt to an over-60s group that is set to drive half of all US spending growth (Middle class meltdown, December 10, 2015)."

Essentially what we are witnessing is a 'Great Unwinding' of policymaker stimulus. Over the past decade, the world's major central banks have deliberately pumped up prices for financial assets via ever-increasing amounts of stimulus and quantitative easing. Their aim was explained by then US Federal Reserve chairman Ben Bernanke in the Washington Post on November 3, 2010: "Higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion."

Their economic models assured them, despite all evidence to the contrary from the real world, that stimulus could somehow return us to the demand levels seen during the BabyBoomer-led SuperCycle. They believed they had become modern 'Masters of the Universe', able to control a global economy of 7.3 billion people with just the touch of a money-printing machine.

Now, the hollowness of this claim is being exposed, as markets return to being based on the fundamentals of supply and demand, rather than tidal waves of central bank liquidity. The end-result is that companies face chaos in both feedstock and product markets. And this chaos could take a long time to resolve itself. Therefore five critical questions will dominate every company's agenda over the next few months:

- Can businesses still plan ahead for demand by simply using a relevant multiple for each product in relation to an IMF GDP growth forecast?
- How will Saudi Arabia's (KSA) new "Vision 2030" impact oil prices? They seem likely to be much lower, for much longer, than consensus wisdom had suggested?
- Do China's New Normal policies mark

a complete change of direction from its previous role as the manufacturing capital of the world?

• Will today's globally ageing population maintain the same levels of demand for autos, housing, electronics etc as in the past?

• How can companies develop a more service-led business model, which emphasises the value created by the product, rather than simply focusing on the product itself?

My key concern is that this chaos will create winners and losers. There will be no middle ground. Winning companies will accept that the world is moving into a New Normal which will be quite different from previous experience. Losers will cling vainly to the hope that change is not inevitable, and that the world will eventually return to the comfortable Old Normal, where constant demand and robust profits were the norm.

These paradigm shifts require a complete change of mind-set. Supply-driven business models were very successful during the BabyBoomer-led economic SuperCycle, when the US economy suffered just 16 months of recession between 1983 – 2007. But today, this model is broken:

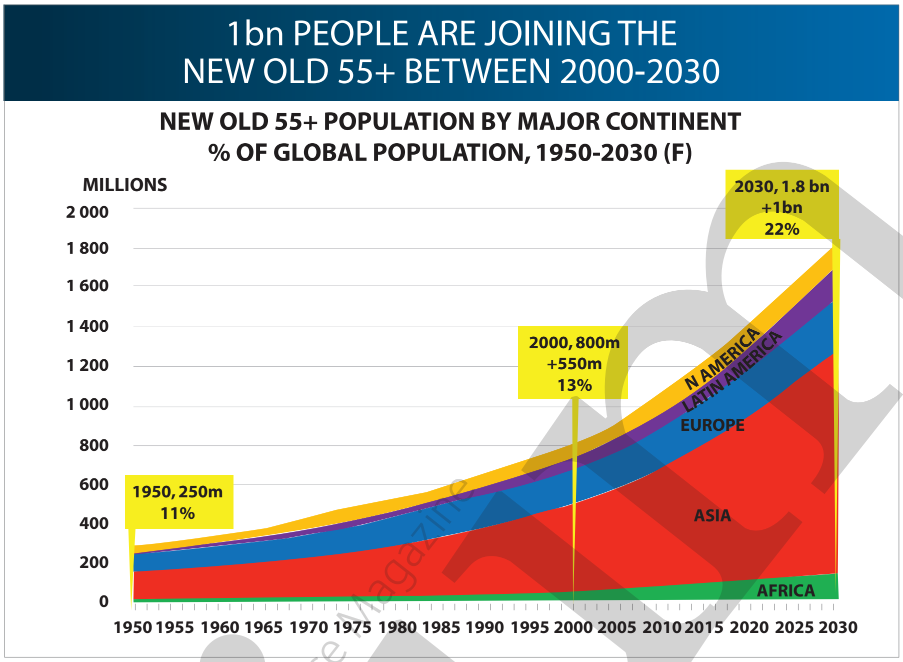
• The Boomers are now moving out of the Wealth Creator 25 – 54 age group, when spending and incomes tend to rise exponentially as people move forward in their careers and often settle down and have children.

• They were then the largest and richest generation in history, but their key characteristic today is that they also have the longest life expectancy. A century ago, total life expectancy was only 50 years.

• At the same time, global fertility rates have collapsed, halving to just 2.5 babies per woman since 1950. This is dramatically reducing the relative size of today's 'Wealth Creator' generation.

• As a result, the world has reached a "demographic cliff", which is creating a "demand cliff" for the global economy.

What does this mean for insurers? It means that the industry can no longer rely on the "build it and they will come" supply-driven business model that has proved so profitable until recently. Anyone opening up new capacity today may have to wait a very long time before demand catches up with the new supply. We are already seeing a resurgence in the use of such as "smart maintenance," which often mean maintenance that takes place only once something goes wrong.



Source: The pH report.

China's move towards a more balanced economy, and a greater emphasis on self-sufficiency, are going to increase this pressure on industry profitability. And in response, we will most likely see a further rise in chemical industry force majeures, as companies seek to compensate for today's more volatile markets by cutting back on maintenance spend. This trend is, of course, taking place when capital has been flooding into the insurance market. Sadly, this means that the industry could be caught in a perfect storm, with the incidence of claims rising at a time when premiums are cyclically depressed.

This is why we argue that winners in this 'New Normal' world now need to abandon their hopes that stimulus programmes will restore former demand patterns. Instead they need to focus on gaining competitive advantage by returning to the successful demand-led business models that operated before the SuperCycle began. As German finance minister Wolfgang Schäuble warned earlier this year at the G20 finance ministers' meeting: "The debt financed growth model has reached its limits. It is even causing new problems, raising debt, causing bubbles and excessive risk taking, zombifying the economy....and may have laid the foundation for the next crisis."

Cycles come and cycles go, but demographic change is long-lasting. The core message of paradigm shift will be critical to future profitability over the next 5 – 10 years, wherever you operate in the insurance industry value chain. Difficult times clearly lie ahead. The good news for potential winners is that the 'New Normal' world is now open for business. Ⓟ

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